Kensington Energy Ltd.

1997 ANNUAL REPORT

CORPORATE PROFILE

KENSINGTON ENERGY LTD. is a junior oil and gas company with operations concentrated in central and northwest Alberta. We focus our efforts on generating drilling opportunities based on producing analogies in western Canada which can lead to significant reserve and production additions for the Company. Kensington's Class A shares and Class B shares trade on The Alberta Stock Exchange under the trading symbols KNN.A and KNN.B respectively.

ANNUAL MEETING

The Annual and Special Meeting of Shareholders will be held at 3:00 p.m. on June 25, 1998 in the Viking Room of the Calgary Petroleum Club located at 319 - 5th Avenue S.W., Calgary, Alberta.

Shareholders are encouraged to attend and those unable to do so are requested to complete and return the proxy form at their earliest convenience.

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ABBREVIATIONS

bbls	barrels
bbl/d	barrels per day
boe	barrels of oil equivalent (1)
boe/d	barrels of oil equivalent per day
mbbl	thousand barrels
mcf	thousand cubic feet
mcf/d	thousand cubic feet per day
mmcf	million cubic feet
mmcf/d	million cubic feet per day
NGLs	natural gas liquids

(1) Natural gas is equated to oil on the basis of: 10,000 cubic feet or 10 mcf = 1 barrel of oil.

FINANCIAL	1997	1996
Petroleum and Natural Gas Sales [1]	$ 2,904,779	$ 748,590
Funds from Operations [1]	$ 1,569,866	$ 483,094
Per Class A Share (Basic)	$ 0.36	$ 0.13
Net Income (Loss) [1] [2]	$ (1,001,868)	$ 129,178
Per Class A Share (Basic)	$ (0.23)	$ 0.04
Working Capital (Deficiency)	$ (576,263)	$ 1,173,844
Long Term Debt	$ 909,473	–
Capital Expenditures	$ 6,814,702	$ 5,265,184
Class A Shares Outstanding		
Weighted Average	4,305,914	3,579,062
Year End	4,999,776	3,790,500
Closing Price	$ 1.45	$ 2.01

OPERATING		
Production [1]		
Oil & NGLs (bbl/d)	209	131
Natural Gas (mmcf/d)	1.87	0.12
Barrels of Oil Equivalent (boe/d)	396	143
Reserves (Proven plus Probable)		
Oil & NGLs (bbls)	635,000	702,000
Natural Gas (mmcf)	1,766	2,815
Undeveloped Land		
Gross Acres	81,904	42,105
Net Acres	30,968	15,095
Drilling Activities		
Gross Wells	23.0	27.0
Net Wells	8.9	8.7

(1) Figures for 1996 are for the 6 months ended December 31, 1996 since the Company did not reach commercial production until July 1, 1996.

(2) The loss for 1997 includes a writedown of oil and gas properties of $840,000 as a result of the application of a ceiling test.

MESSAGE TO THE SHAREHOLDERS

During 1997, Kensington had a number of significant achievements, including the following:

- average production was 396 boe/d compared to 143 boe/d in 1996
- cash flow was $1,569,866 or $0.36 per Class A share (basic) compared to $483,094 or $0.13 per Class A share (basic) in 1996
- the undeveloped land base doubled from 42,105 gross acres (15,095 net acres) to 81,904 gross acres (30,968 net acres) — an important asset from which the Company's future drilling prospects will come
- continued development of a strong inventory of drillable prospects needed for future growth

As well as these accomplishments, the Company encountered some disappointments during the year. Implementation of the waterflood at the Giroux Lake oil pool was delayed due to unitization issues which resulted in production and cash flow which was below expectations. However, water injection has now begun. Restriction of gas production by a gas plant at Sangudo had a similar effect on production and cash flow. Kensington sold its Sangudo gas property for cash, effective March 1, 1998. The proceeds from this sale were a significant premium to the value assigned to this property by Kensington's independent evaluation engineers.

Our exploration program yielded no significant results in 1997 after a very good year in 1996. Two questions that may emerge as a result of this are:
i) can the drilling results be substantially better in 1998 and beyond?
ii) can the Company finance sufficient drilling activity needed to increase reserves, production and cash flow?

Our answer to these two questions is an unqualified 'yes'. The foundation for any oil and gas company is an inventory of high quality drilling prospects and a motivated, skilled group of professionals to continue to develop and advance these prospects. Kensington has both the people and a current inventory of prospects to go forward and make significant additions to reserves, production and cash flow.

The Company will be able to finance its 1998 drilling program from cash flow, proceeds from the sale of the Sangudo property and prudent use of its credit facility. Kensington's cash flow comes from a quality, high netback production base which is important during the current period of low oil prices. The Company also hedged 100 bbl/d of its oil production for the first 6 months of 1998 at approximately US $20.28 per barrel, a significant premium to current prices of approximately US $16.00 per barrel.

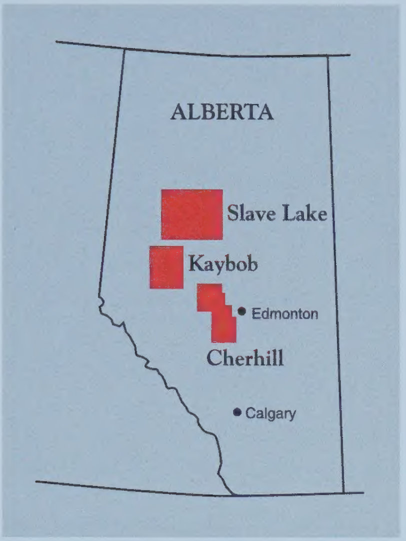
In addition, some of our internally generated prospects will be evaluated by farm-outs in which other companies will commit to drill wells in order to earn an interest in our land. This will allow Kensington to have more prospects evaluated by drilling without increasing our capital budget.

The talent, hard work and dedication of our employees, consultants and directors is a crucial asset for the Company — we believe Kensington has an excellent work environment which fosters the kind of creative and forward thinking approach that is needed for success. We would also like to thank our shareholders for their patience and support.

On behalf of the Management and the Board,

Kevin McLachlan

Kevin McLachlan
President
May 4, 1998



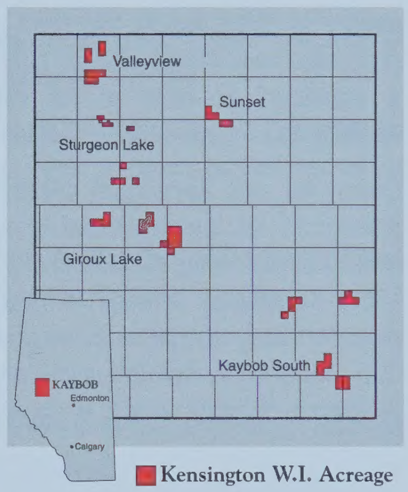
Kensington Focus Areas

Kensington's growth philosophy is to develop a large number of drilling opportunities, each of which can lead to significant reserve and production additions for the Company. The amount of risk capital invested in any single prospect is limited to allow the Company to test most of these prospects through drilling, thus exposing the Company to the potential upside from a large portfolio of exploration and exploitation prospects.

The Company continues to have a large, high quality prospect inventory and large undeveloped land base. During 1998 we will continue to have these ideas tested with the drill bit.

Kaybob Area

The Kaybob area continued to be the Company's major area of focus with 14 wells drilled in this region during 1997.



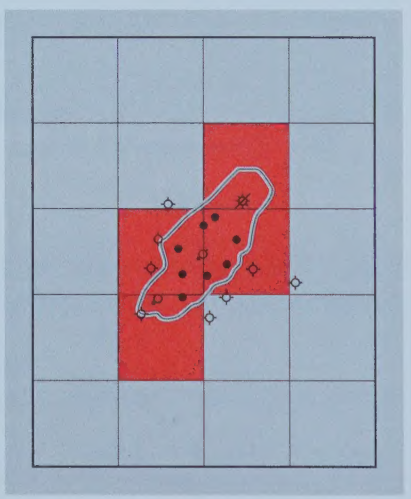
Kensington W.I. Acreage

Giroux Lake

At Giroux Lake, Kensington drilled 7 wells in 1997 to establish the limits of the light oil pool discovery it made here in June, 1996. The Company has a 40% interest in this pool. Of these 7 wells, 4 are producing oil wells, one is cased as a potential oil well, one is a shut-in gas well and one well was dry and abandoned. Production at the Giroux Lake pool is currently restricted by the Alberta Energy and Utilities Board pending implementation of a waterflood. These production restrictions will be lifted once the waterflood is fully implemented which is expected to occur by August of 1998. During 1997, Kensington also constructed a central battery, flowlines and a sales pipeline. As a result of this capital investment, trucking costs were eliminated during the last 6 months of 1997 and operating costs averaged $2.80 per bbl during the same period.

The Giroux Lake oil pool is now a premium asset for the Company. The pool produces sweet, 38° API oil with low operating costs and high netbacks. Kensington's net production from Giroux Lake averaged 130 bbl/d in 1997. Current net production is approximately 130 bbl/d which is expected to increase to approximately 220 bbl/d by August, 1998.

Kensington also drilled 3 exploration wells in the Giroux Lake area in 1997. Two of these wells were dry and abandoned while the third is cased as a potential oil well which requires further evaluation. Kensington has an average 31% working interest in 18.25 sections (11,680 acres) of exploration acreage in the Giroux Lake area. Further exploration drilling in the area is being considered.



Giroux Lake

Valleyview/Sunset

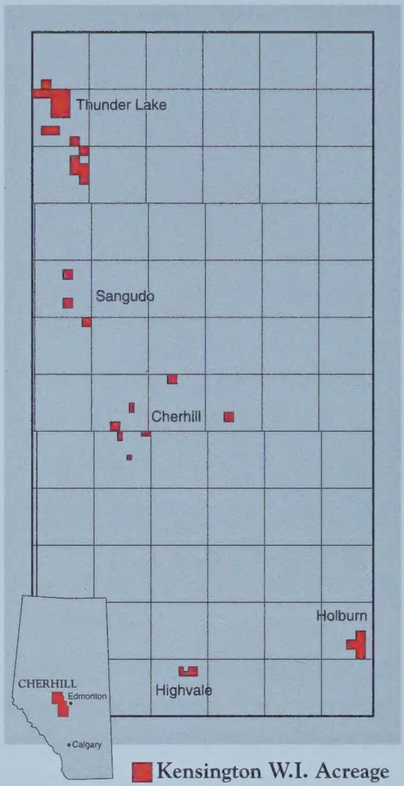
During the year Kensington drilled 2 exploration wells in this area which were both dry and abandoned. One of the wells encountered significant oil shows in the target formation. The Company is considering drilling a second well here to follow-up on this strong lead. Kensington has an average 32% working interest in 16 sections (10,240 acres) of exploration acreage in the area.

Kaybob South

Kensington drilled 2 wells at Kaybob South in 1997: one has been tied-in as a gas well while the second is cased as a potential gas well subject to additional testing. The Company has an average 20% working interest in 13 sections (8,320 acres) of undeveloped land at Kaybob South.

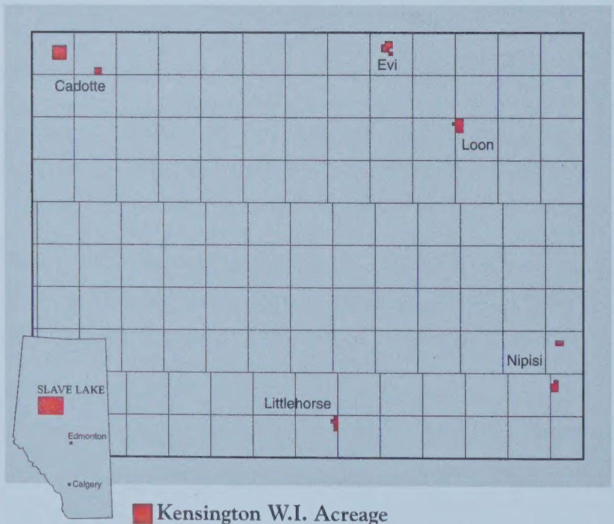
Cherhill Area

Kensington's production averaged 165 boe/d from Sangudo in 1997 consisting of 1.26 mmcf/d of gas and 39 bbl/d of NGLs from the Nordegg sand. Production volumes have been restricted here since late in the third quarter of 1997 due to gas plant restrictions. Kensington has sold its production here effective March 1, 1998. The proceeds from this sale were a significant premium to the value assigned to this property by Kensington's independent evaluation engineers.



Kensington W.I. Acreage

During the year Kensington drilled 2 exploration wells for Nordegg gas prospects in this area which both encountered Nordegg sand which was not hydrocarbon bearing. An additional well was drilled by another company on 100% Kensington acreage to evaluate an internally-generated drilling prospect which resulted in a new pool gas discovery. Kensington retains a 15% royalty in this well until payout and a 40% working interest after payout. We plan to do further drilling in this area later in 1998. The Company has its largest undeveloped land position in the Cherhill area consisting of an average 48% working interest in 33 sections (21,120 acres).



Kensington W.I. Acreage

Slave Lake Area

In 1997 the Company participated in 3 exploration wells in the Slave Lake area which resulted in one new pool oil discovery, one dry and abandoned well and one well which had to be abandoned due to mechanical difficulties. Kensington has an average 32% working interest in 10.75 sections (6,880 acres) of undeveloped land in the Slave Lake area.

Other Areas

The Company is also developing several high impact prospects as a result of detailed regional geological and seismic work. We expect to have a land position assembled on these prospects in several months with evaluation by drilling to begin later this year and early next year.

Future Activities

Kensington is planning to have a number of exploitation and exploration projects evaluated by drilling later this year. A few of these are described below.

Two of these projects involve re-entering several vertical wells and drilling horizontally through the target formation. In both projects, Kensington has identified an extensive oil-bearing reservoir sand which produces reasonable amounts of oil from vertical wells. However, reservoir modeling of these sands indicates that horizontal wells can recover significantly more oil at much higher production rates. The oil quality is medium to light gravity in both of these projects. It is our intention to have a well drilled in each area later this year. Several follow-up locations exist on both projects.

In southern Alberta, a new Glauconite oil discovery has recently been drilled offsetting Kensington land. One or more drilling locations may exist on our acreage, and a well may be drilled here this summer.

Kensington has identified a play type and exploration fairway with large, light oil pool potential. A number of prospects have been seismically defined and land acquisition is in progress. These prospects will be farmed-out once a sufficient land position is acquired.

In total, it is anticipated that 10 to 15 prospects will be evaluated in 1998 by a combination of Company drilling and farm-outs.

Reserves and Present Value

The tables below summarize the results of independent engineering evaluations of the Company's reserves prepared by Brusset Consultants as of January 1, 1998.

As of January 1, 1998				Present Value ($000s) before Income Taxes Discounted at			
Reserves (before royalties)	Oil (mbbl)	NGLs (mbbl)	Pipeline Gas (mmcf)	0%	10%	15%	20%
Proven	369	18	665	7,826	5,863	5,218	4,710
Probable	150	98	1,101	7,201	4,172	3,477	3,014
Total	519	116	1,766	15,027	10,035	8,695	7,724

Of the total oil reserves, 506,000 barrels or 97% is sweet, 38° API oil.

Reconciliation of Changes in Reserves

The following table provides the changes in Kensington's reserves from December 31, 1996 to December 31, 1997.

	Oil & NGLs (mbbls)			Gas (mmcf)		
	Proven	Probable	Total	Proven	Probable	Total
December 31, 1996	383.0	319.0	702.0	1,681.0	1,134.0	2,815.0
Discoveries during 1997	12.0	12.0	24.0	307.0	357.0	664.0
Production during 1997	(76.3)	–	(76.3)	(683.8)	–	(683.8)
Divestments	(3.1)	(5.0)	(8.0)	–	–	–
Revision of prior estimates	71.4	(78.0)	(6.6)	(639.2)	(390.0)	(1,029.2)
December 31, 1997	387.0	248.0	635.0	665.0	1,101.0	1,766.0

Finding and Onstream Costs

	Total	1997	1996	1995
Finding Costs				
Land acquisition	$ 1,552,930	**$ 504,634**	$ 714,799	$ 333,497
Seismic and geological	1,429,658	**553,236**	422,684	453,738
Drilling and completion	8,384,295	**4,397,591**	3,385,613	601,091
Capitalized general and administrative	1,012,608	**357,786**	459,823	194,999
	12,379,491	**5,813,247**	4,982,919	1,583,325
Onstream Costs				
Well equipping	457,306	**385,085**	51,008	21,213
Gathering	320,960	**97,221**	209,140	14,599
Facilities	473,076	**473,076**	–	–
	1,251,342	**955,382**	260,148	35,812
	$13,630,833	**$6,768,629**	$ 5,243,067	$ 1,619,137
Total Reserve Additions (boes)	985,980	**(27,211)**	999,995	13,196
Finding Costs (per boe)	$ 12.55	–	$ 4.98	
Onstream Costs (per boe)	1.27	–	0.26	
Total Finding and Onstream Costs (per boe)	$ 13.82	–	$ 5.24	

While finding and onstream costs for exploration companies like Kensington can vary significantly from year to year, the Company's cumulative finding and onstream costs have risen to unacceptably high levels. In order to reverse this trend, we have thoroughly re-examined the Company's strategy in order to identify its weaknesses and strengths. As a result, we have developed a number of lower risk exploitation ideas in addition to exploration ideas to create a more balanced portfolio of opportunities. Leverage will be obtained from prospects developed on 100% Kensington acreage by farming these ideas out where appropriate. Kensington will not abandon the strengths of its strategy. The key ones are to develop prospects in high quality reservoirs which have excellent productivity and reserve potential and to spread the risk among a large number of drilling opportunities.

Drilling Activity

During the year, Kensington participated in the drilling of 23 gross (8.91 net) wells. Of these wells, 15 were exploration wells and 8 were development wells. The table below summarizes the Company's drilling activity.

	Exploration		Development		Total	
	Gross	Net	Gross	Net	Gross	Net
Oil	2	0.83	6	2.06	8	2.89
Gas	2	0.50	1	0.31	3	0.81
D&A	11	4.81	1	0.40	12	5.21
Total	15	6.14	8	2.77	23	8.91

In addition to the above wells in which Kensington participated, the Company farmed-out its interest in 3 prospects which were drilled during the year resulting in 1 new pool gas discovery and 2 dry and abandoned wells.

During 1997 the Company evaluated 15 different exploration ideas through drilling. In 1998 Kensington expects to have 10 to 15 exploration and exploitation ideas evaluated by a combination of Company drilling and farm-outs.

Undeveloped Land

Kensington's undeveloped land position increased by 95%, from 42,105 gross acres at the beginning of the year, to 81,904 at the end of the year. On a net undeveloped basis, our position increased by 105% from 15,095 acres to 30,968 acres.

	1997	1996
Gross acres (1)	**81,904**	42,105
Net acres (2)	**30,968**	15,095
Average working interest (%)	**37.8**	35.9

(1) "Gross acres" means the area of land in which Kensington has a working interest.
(2) "Net acres" means the sum of the products obtained by multiplying the number of gross acres by Kensington's percentage working interest therein.

Kensington began to acquire land at a 100% working interest in late 1997 with the intention of farming-out the drilling of prospects on this acreage. This land acquisition strategy will continue in 1998.

The following discussion and analysis is a review of the financial and operating results of Kensington Energy Ltd. for 1997 and 1996 and should be read in conjunction with the audited financial statements and related notes in this annual report. The Company achieved commercial production July 1, 1996, so the results for 1996 represent a 6 month period.

Revenue

Revenue from petroleum and natural gas sales increased by 288% from $748,590 in 1996 to $2,904,779 in 1997. Revenue in 1997 increased because average production rates in 1997 of 396 boe/d were substantially higher than the 143 boe/d in the 1996 period. These higher production volumes in 1997 also more than offset the effect of lower product prices in 1997 versus 1996.

A breakdown of revenue by product is shown in the table below:

	1997		1996	
Product	Total	Per BOE	Total	Per BOE
Oil	**$1,430,245**	**$24.75**	$680,945	$28.89
Natural Gas	**1,157,221**	**16.92**	47,070	20.97
NGLs	**317,313**	**17.14**	20,575	33.90
Total	**$2,904,779**	**$20.08**	$748,590	$28.33

Royalties and ARTC

Royalties to the Crown, freehold owners and third parties for 1997 were $622,907 ($4.31 per boe) compared to $156,395 in 1996 ($5.92 per boe). Total royalties in 1997 were higher than in 1996 due to higher production volumes. During 1997, $270,862 ($1.87 per boe) was recovered under the Alberta Royalty Tax Credit (ARTC) program compared to $72,501 ($2.74 per boe) in 1996.

Interest Income

Interest income was $8,353 in 1997 compared to $28,606 in 1996. In early 1996, the Company received $2,947,000 in proceeds as part of its initial public offering. As a result, the Company had higher cash balances in 1996, resulting in greater interest income.

Production Expenses

Production expenses were $615,016 ($4.25 per boe) in 1997 compared to $106,532 ($4.03 per boe) in 1996. Total production expenses in 1997 were higher than in 1996 due to higher production volumes but continued to be low on a per boe basis due to the high quality of the Company's production. Production expenses were even lower during the last 6 months of 1997 and averaged $3.85 per boe primarily due to lower expenses at Giroux Lake.

General and Administrative

General and administrative expenditures are shown in the table below:

	1997	1996
Total General and Administrative Expenditures	**$ 781,210**	$ 563,499
Less Overhead Recoveries	**(55,867)**	–
Less Capitalized as Part of Petroleum and Natural Gas Properties	**(357,786)**	(459,823)[1]
General and Administrative Expense	**$ 367,557**	$ 103,676
Per Boe	**$ 2.54**	$ 3.92

(1) During 1996, $285,155 of G&A costs were capitalized during the Company's preproduction stage.

Total general and administrative costs were $781,210 in 1997 compared to $563,499 in 1996 primarily due to increased staff and space requirements. Kensington recovered $55,867 of these costs in 1997 as the result of operating a portion of its capital program. Consistent with full cost accounting, Kensington capitalizes those costs that are applicable to exploration activities which amounted to approximately 50% of general and administrative expenditures after overhead recoveries in 1997.

Interest Expense

Interest expense was $8,648 during 1997 as a result of utilizing a portion of the Company's credit facility. This credit facility was not utilized in 1996.

Depletion, Depreciation and Amortization

	1997		1996	
	Total	Per BOE	Total	Per BOE
Depletion	$1,517,769	$10.49	$144,998	$5.49
Depreciation	17,470	0.12	3,764	0.14
Site Restoration	29,810	0.21	3,154	0.12
Total	$1,565,049	$10.82	$151,916	$5.75

Total depletion, depreciation and amortization (DD&A) expense was $1,565,049 ($10.82 per boe) compared to $151,916 ($5.75 per boe) in 1996. Total DD&A was higher in 1997 due to higher production and significantly higher depletion expense per boe.

Writedown of Oil and Gas Properties

The Company applies an annual ceiling test to the net book value of property and equipment to ensure that this value does not exceed the estimated future net revenue from production of proven reserves (revenue net of royalties, production expenses, general and administrative costs, financing costs, estimated future site restoration and abandonment costs and income taxes) plus the lower of cost and estimated fair market value of unproved properties.

As a result of this ceiling test, it was determined that a writedown of $840,000 was required for 1997.

Deferred Income Taxes

The Company's deferred income tax provision was $166,685 in 1997 compared to $202,000 in 1996.

Net Income and Funds From Operations

In 1997 Kensington had a loss before income taxes of $835,183 and a loss for the period of $1,001,868 including the writedown of oil and gas properties. Without this writedown, the Company would have had a small profit of $4,817 before income taxes. Higher depletion expenses in 1997 also resulted in reduced income before income taxes. Income before income taxes was $331,178 in 1996 and $129,178 after taxes.

Funds from operations increased to $1,569,866 in 1997 from $483,094 in 1996 primarily due to higher production volumes.

BOE Analysis

The following table analyzes field netbacks, funds from operations and net income on a boe basis.

	1997	1996
Revenue	$ 20.08	$ 28.33
Royalties	(4.31)	(5.92)
ARTC	1.87	2.74
Production Expenses	(4.25)	(4.03)
Field Netback	13.39	21.12
Interest Income	0.06	1.08
General and Administrative	(2.54)	(3.92)
Interest Expense	(0.06)	–
Funds from Operations	10.85	18.28
Depletion, Depreciation and Amortization	(10.82)	(5.75)
Writedown of Oil and Gas Properties	(5.81)	
Deferred Income Tax	(1.15)	(7.65)
Net Income	(6.93)	4.88

Capital Expenditures

Capital expenditures for 1997 were $6,814,702, an increase of 29% over the $5,265,184 reported in 1996. The following table provides a comparative analysis of capital expenditures for 1997 and 1996.

	1997	1996
Land Acquisition	$ 504,634	$ 714,799
Seismic and Geological	553,236	422,684
Drilling and Completion	4,397,591	3,385,613
Capitalized G&A	357,786	459,823
Well Equipping	385,085	51,008
Gathering	97,221	209,140
Facilities	473,076	–
Furniture and Equipment	46,073	22,117
	$6,814,702	$ 5,265,184

Net Asset Value

	December 31, 1997	
Assets	Reserve Value Discounted @ 10%	Reserve Value Discounted @ 15%
Reserves (proven + half probable value)	$ 7,949,000	$ 6,956,500
Undeveloped Land	2,477,440	2,477,440
Working Capital	(576,263)	(576,263)
Proprietary Seismic and Other Assets	865,769	865,769
Total Assets	10,715,946	9,723,446
Liabilities		
Long Term Debt	(909,473)	(909,473)
Net Asset Value	$ 9,806,473	$ 8,813,973
Class A Shares Outstanding	4,999,776	4,999,776
NAV Per Class A Share - basic	$ 1.96	$ 1.76
- fully diluted (1)	$ 0.98	$ 0.88

(1) Assumes conversion of 1,624,000 Class B shares using the year end Class A share price of $1.45, exercise of 372,000 options for proceeds of $567,850, exercise of 308,000 flow-through exchange rights and issuance of 450,000 Class A shares reserved for issue at year end.

Liquidity and Capital Resources

The Company's capital expenditures have been financed by funds from operations, equity issues, bank debt and working capital deficiency. In 1997 Kensington financed its capital program from $1,732,924 in cash remaining from 1996 equity proceeds, $1,569,866 from funds from operations, $2,585,256 from equity issues (net of issue costs and repurchased shares), $909,473 from bank debt and $17,183 from an increase in non-cash working capital deficiency.

During the year the Company received proceeds, net of issue costs, of $2,691,497 from the issue of Class A shares as a result of the exercise of outstanding warrants and flow-through share issues. The Company also repurchased for cancellation 68,000 Class A shares pursuant to its normal course issuer bid for total consideration, including costs, of $106,241. Kensington established a $1,000,000 credit facility during 1997. At year end, $909,473 was drawn on this facility. Subsequent to year end this credit facility was increased to $2,000,000.

Year 2000 Compliance

The Company has begun the process of reviewing its computer hardware and software in order to assess potential problems associated with the year 2000. All of the software used by Kensington is provided by third parties for use in accounting, land, exploration, engineering and office administration. As part of its assessment, the Company will be contacting all of its software suppliers to determine year 2000 compliance. The Company has received confirmation from the supplier of its accounting system that the hardware and software used in this system is year 2000 compliant. All costs associated with this issue will be expensed as incurred. These costs are not expected to have a material effect on the financial results of the Company.

Business Risks

Exploring for, acquiring, developing, producing and marketing oil and natural gas involve a number of business risks and uncertainties which have the potential to significantly affect operating and financial results. These include exploration risk, reservoir performance, commodity prices, competition and government regulation.

Exploration risk relates to Kensington's ability to economically find and develop new reserves. This risk is mitigated by using skilled and experienced staff, focusing exploration efforts in areas in which we have existing knowledge and expertise, using the latest technologies and controlling costs to maximize profitability. In addition, the Company undertakes a significant portion of its exploration activities jointly with industry partners to spread exploration risk over a larger number of wells.

Forecasted production from oil and gas reservoirs may decline more quickly than anticipated, resulting in lower cash flow and lower reserve recovery. In an effort to mitigate this risk, Kensington focuses on exploring for high quality reservoirs with more predictable decline characteristics. The prices that Kensington receives for oil, natural gas and NGLs are volatile and subject to a number of external factors over which we have no control. World oil prices are affected by global supply and demand balances, political stability, the actions of OPEC and economic conditions in the major oil consuming countries. Gas prices are affected by supply and demand balances in North America, the availability of pipeline transportation and prices for competing fuels. Kensington will endeavor to hedge a portion of its production at certain times in order to eliminate some pricing risk.

Kensington's activities are all currently in Western Canada. Competition for petroleum and natural gas leases and drilling prospects can be very strong at certain times in certain areas. Kensington attempts to mitigate this risk by avoiding areas where it believes that the economics of oil and gas production would be significantly reduced by intense competition.

The operations of oil and gas producers are subject to extensive controls and regulation by various levels of government, and there is risk that changes in government policies and regulations could adversely impact Kensington's operations.

MANAGEMENT'S REPORT

Management is responsible for the integrity and objectivity of the information contained in this annual report and for the consistency between the financial statements and other financial and operating data contained elsewhere in the report. The accompanying financial statements have been prepared by management in accordance with accounting principles generally accepted in Canada using estimates and careful judgement, particularly in those circumstances where transactions affecting a current period are dependent upon future events. The accompanying financial statements have been prepared using policies and procedures established by management and reflect fairly the Company's financial position, results of operations and changes in financial position, within reasonable limits of materiality and within the framework of the accompanying policies outlined in the notes to the financial statements.

Management has established and maintains a system of internal control which is designed to provide reasonable assurance that assets are safeguarded from the loss or unauthorized use and the financial information is reliable and accurate.

The financial statements have been examined by external auditors. Their examination provides an independent view as to management's discharge of its responsibilities insofar as they relate to the fairness of reported operating results and financial condition of the Company.

The Audit Committee of the Board of Directors has reviewed in detail the financial statements with management and the external auditors. The financial statements have been approved by the Board of Directors on the recommendation of the Audit Committee.

Kevin McLachlan

Kevin McLachlan
President

March 11, 1998

AUDITORS' REPORT

To the Shareholders of Kensington Energy Ltd.

We have audited the balance sheets of Kensington Energy Ltd. as at December 31, 1997 and 1996 and the statements of (loss) income and (deficit) retained earnings for the year ended December 31, 1997 and the six month period ended December 31, 1996 and cash flow for each of the years ended December 31, 1997 and 1996. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1997 and 1996 and the results of its operations for the year ended December 31, 1997 and the six month period ended December 31, 1996 and the changes in its financial position for each of the years ended December 1997 and 1996 in accordance with generally accepted accounting principles.

Ernst & Young

Calgary, Canada

March 11, 1998

Chartered Accountants

As at December 31	1997	1996
	$	$
ASSETS [note 4]		
Current		
Cash and short term deposits	–	1,732,924
Accounts receivable [note 5]	1,507,033	493,574
	1,507,033	2,226,498
Property and equipment [note 3]	10,223,830	4,197,949
Accumulated depletion and depreciation	(2,524,001)	(148,762)
	7,699,829	4,049,187
Deferred income taxes	–	150,167
	9,206,862	6,425,852
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	2,083,296	1,052,654
	2,083,296	1,052,654
Long term debt [note 4]	909,473	–
Site restoration and abandonment provision	32,964	3,154
Shareholders' equity		
Share capital [note 5]	7,053,819	5,240,866
(Deficit) retained earnings	(872,690)	129,178
	6,181,129	5,370,044
Commitment [note 8]		
	9,206,862	6,425,852

See accompanying notes

Approved by the Board:

Kevin McLachlan

Director

Director

STATEMENTS OF (LOSS) INCOME AND (DEFICIT) RETAINED EARNINGS

	For the year ended December 31, 1997 $	For the six month period ended December 31, 1996 $
Revenue		
Petroleum and natural gas sales	2,904,779	748,590
Royalties	(622,907)	(156,395)
Alberta royalty tax credit	270,862	72,501
Interest income	8,353	28,606
	2,561,087	693,302
Expenses		
Production	615,016	106,532
General and administrative [note 3]	367,557	103,676
Interest on long term debt	8,648	–
Depletion, depreciation and amortization	1,565,049	151,916
Writedown of oil and gas properties [note 3]	840,000	–
	3,396,270	362,124
(Loss) income before income taxes	(835,183)	331,178
Deferred income tax provision [note 6]	(166,685)	(202,000)
(Loss) net income for the period	(1,001,868)	129,178
Retained earnings, beginning of period	129,178	–
(Deficit) retained earnings, end of period	(872,690)	129,178
(Loss) earnings per Class A share [note 7]		
Basic	(0.23)	0.04
Fully diluted	(0.23)	0.02

See accompanying notes

For the year ended December 31	1997 $	1996 $
Operating activities		
(Loss) net income	(1,001,868)	129,178
Add non-cash items		
Depletion, depreciation and amortization	1,565,049	151,916
Writedown of oil and gas properties	840,000	–
Deferred income taxes	166,685	202,000
Funds from operations	1,569,866	483,094
Changes in non-cash working capital items	41,015	21,334
	1,610,881	504,428
Financing activities		
Issue of Class A shares	1,986,459	496,125
Subscriptions for Class A shares	742,500	–
Issue of flow-through exchange rights	–	699,160
Issue of Class B shares	–	2,947,000
Deferred income taxes	(16,518)	(23,443)
Share issue costs	(20,944)	(29,836)
Class A shares repurchased and cancelled	(106,241)	–
Increase in long term debt	909,473	
	3,494,729	4,089,006
Investing activities		
Property and equipment	(6,814,702)	(5,265,184)
Changes in non-cash working capital items	(23,832)	470,185
	(6,838,534)	(4,794,999)
Decrease in cash and short term deposits	(1,732,924)	(201,565)
Cash and short term deposits, beginning of year	1,732,924	1,934,489
Cash and short term deposits, end of year	–	1,732,924
Funds from operations per Class A share [note 7]		
Basic	0.36	0.13
Fully diluted	0.17	0.06

See accompanying notes

December 31, 1997

1. INCORPORATION AND COMMENCEMENT OF OPERATIONS

The Company was incorporated under the laws of the Province of Alberta on January 25, 1995. The Company's business is the acquisition of petroleum and natural gas rights and the exploration for, development and production of, crude oil and natural gas.

The Company was in the preproduction stage from January 25, 1995 to June 30, 1996 and during this period, all costs net of revenues were deferred. Effective July 1, 1996 production at commercial levels was attained and all of the deferred exploration costs were transferred to the Company's full cost pool. Accordingly, the comparative statement of (loss) income and (deficit) retained earnings for 1996 reflects the Company's operations for the six month period ended December 31, 1996.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Property and equipment

Capitalized costs

The Company follows the full cost method of accounting whereby all costs related to the exploration for and the development of petroleum and natural gas reserves are initially capitalized.

Capitalized costs include lease acquisition, geological and geophysical expenditures, lease rentals on non-producing properties, costs of drilling both productive and non-productive wells, equipment costs and that portion of general and administrative expenses applicable to these activities.

Proceeds from disposal of properties will normally be applied as a reduction of the cost of the remaining assets unless the disposal results in a change in the depletion rate of greater than 20%, in which case a gain or loss on disposal will be recorded.

Depletion and depreciation

Depletion of petroleum and natural gas properties and depreciation of production equipment is provided for using the unit of production method based on estimated proved petroleum and natural gas reserves, as determined by independent engineers.

The depletion and depreciation cost base includes total capitalized costs, less costs of unproved properties, plus provision for future development costs of proved undeveloped reserves, as determined by independent engineers. Costs incurred for facilities under construction at year end are excluded from the cost base.

The relative volumes of oil and gas reserves and production are converted at a ratio of ten thousand cubic feet of gas to one barrel of oil.

Computer equipment and furniture is carried at cost and are depreciated over the estimated useful lives of the assets at rates of 25% calculated on a declining basis.

Site restoration and abandonment

Estimated future site restoration and abandonment costs are accrued on the unit of production method. Estimates are based on costs and regulations in effect at year end. The annual charge is included in depletion , depreciation and amortization expense.

Ceiling test

The Company applies an annual ceiling test to capitalized costs, net of deferred income taxes and the site restoration provision, to ensure that the net carrying value does not exceed the estimated value of future net revenues from production of proved reserves less future production related general and administrative expenses, financing costs, estimated future site restoration and abandonment costs and income taxes, plus the lower of cost and estimated fair market value of unproved properties. Any reduction in value, as a result of the ceiling test, will be charged to operations.

The calculation of future net revenues is based on wellhead prices and costs, and the income tax and Alberta royalty tax credit legislation in effect at year end.

Flow-through shares

The Company has financed the majority of its exploration and development activities through the issue of flow-through shares. Under the terms of the flow-through share issues, the tax attributes of the related expenditures are renounced to subscribers. To recognize the foregone tax benefits to the Company, the carrying value of the properties acquired and the shares issued are recorded net of the tax benefits renounced to subscribers when the expenditures are incurred.

Joint operations

Substantially all of the Company's exploration and development activities are conducted jointly with others and, accordingly, these financial statements reflect only the Company's proportionate interest in such activities.

Financial instruments

Financial instruments of the Corporation consist of cash and short term deposits, accounts receivable, accounts payable and long term debt. As at December 31, 1997 there are no significant differences between their carrying values and their estimated market values.

Measurement uncertainty

The amount recorded for depletion of oil and gas properties is based on estimates. The ceiling test calculation is based on estimates of proved reserves, production rates, oil and gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future years could be significant.

3. PROPERTY AND EQUIPMENT

	1997		1996	
	Cost	**Net Book Value**	Cost	Net Book Value
	$	**$**	$	$
Petroleum and natural gas properties	**13,630,873**	**11,129,413**	6,862,204	6,718,553
Tax benefits renounced	**(3,505,029)**	**(3,505,029)**	(2,716,208)	(2,716,208)
Computer equipment and furniture	**97,986**	**75,445**	51,953	46,842
	10,223,830	**7,699,829**	4,197,949	4,049,187

As at December 31, 1997 property and equipment includes unproved properties of $2,003,697 (1996 - $947,000) which have been excluded from costs subject to depletion.

The Company applied the ceiling test to the capitalized amounts of petroleum and natural gas properties and production equipment at December 31, 1997, and has determined that a writedown of $840,000 was required. The writedown has been applied to increase accumulated depletion and depreciation.

The Company capitalized all of its general and administrative costs while in the pre-production stage. In the last half of 1996 and during 1997, the Company capitalized 50% of general and administrative charges, net of overhead recoveries. Details are as follows:

	1997	1996
	$	$
Total general and administrative expenditures	**725,343**	563,499
Less capitalized as part of petroleum and natural gas properties		
During pre-production stage	**–**	(285,155)
During production stage	**(357,786)**	(174,668)
General and administrative expense	**367,557**	103,676

4. LONG TERM DEBT

As at December 31, 1997, the Corporation has a $1,000,000 revolving production loan facility (December 31, 1996 - nil), due on demand bearing interest at bank prime rate plus 3/4%. The bank has indicated that, while it reserves the right to request payment on demand, it is not its intention to call for repayment before December 31, 1998 provided that there is no adverse change in the financial position of the Company. Accordingly, the loan is classified as long term.

The Corporation has pledged as collateral a general security agreement and a first floating charge demand debenture over all of the Corporation's assets. The credit facility will be reviewed by the bank annually. At December 31, 1997, $909,473 was drawn on this facility.

Subsequent to year end, the Company established with the bank a $2,000,000 revolving production loan facility with similar terms and conditions.

5. SHARE CAPITAL

Authorized

Unlimited number of Class A common shares, voting, with no par value.

Unlimited number of Class B common shares, voting, with no par value.

Issued and outstanding

	1997		1996	
	Number of Shares	**Consideration $**	Number of Shares	Consideration $
Class A Shares				
Balance, beginning of year	**3,790,500**	**1,909,285**	3,570,000	714,000
Exercise of Options	**15,000**	**19,500**	–	–
Exercise of Warrants	**771,976**	**1,157,964**	–	–
Pursuant to private placement	**490,300**	**808,995**	220,500	496,125
Issue of flow-through exchange rights	–	–	–	699,160
Repurchased and cancelled	**(68,000)**	**(106,241)**	–	–
Less: tax benefits related to renounced expenditures	–	**(663,728)**	–	–
Balance, end of year	**4,999,776**	**3,125,775**	3,790,500	1,909,285
Class B Shares				
Balance, beginning of period	**1,624,000**	**3,779,792**	887,250	2,918,514
Pursuant to initial public offering	–	–	736,750	2,947,000
Less: tax benefits related to renounced expenditures	–	**(125,093)**	–	(2,085,722)
Balance, end of year	**1,624,000**	**3,654,699**	1,624,000	3,779,792
Share issue costs, net of deferred income taxes	–	**(469,155)**	–	(448,211)
Reserved for issue				
Class A Shares				
Balance, beginning of period	–	–	–	–
Pursuant to Private Placement	**450,000**	**742,500**	–	–
Balance, end of year	**450,000**	**742,500**	–	–
Class B Shares				
Balance, beginning of year	–	–	736,750	2,947,000
Pursuant to initial public offering	–	–	(736,750)	(2,947,000)
Balance, end of year	–	–	–	–
Share capital, end of year	–	**7,053,819**	–	5,240,866

Initial public offering

On August 16, 1995 the Company closed it initial public offering of 7,000 units. Each $1,000 unit consisted of 360 Class A common shares (the Class A shares), 232 Class B flow-through common shares (the Class B shares) and 180 Class A common share purchase warrants. The subscription price for each unit was applied as to $72 to purchase 360 Class A shares at $0.20 per share and as to $928 to purchase 232 Class B shares at $4.00 per share. Subscribers were given the option of paying for their units at closing or in two instalments with the final instalment due January 2, 1996. A total of 2,520,000 Class A shares and 887,250 of the Class B shares were issued on closing of the offering.

The Class A shares and 887,250 of the Class B shares were issued for cash; 736,750 Class B shares were reserved for issue pursuant to the instalment agreement. Subsequent to December 31, 1995, $2,947,000 of share subscriptions receivable were received and the 736,750 Class B shares were issued.

The Class B shares will be convertible into Class A shares at the Company's option at any time after June 30, 1998 and before June 30, 2000. The fraction of a Class A share obtained upon conversion of each Class B share will be equal to $4.00 divided by the greater of $1.00 or the current market price of the Class A shares at that time. Should the Company fail to exercise the conversion option by June 30, 2000, the Class B shares are convertible, at the option of the shareholder, at any time after July 1, 2000 and before August 31, 2000 into Class A shares. Any Class B shares not converted to Class A shares by August 31, 2000 are deemed to be converted at that time. Such conversion would result in a maximum of 6,496,000 Class A shares being issued.

In accordance with the terms of the initial public offering and pursuant to certain provisions of the Income Tax Act (Canada), the Company was required to renounce, for income tax purposes, to the holders of the Class B shares $6,496,000 of exploration and development expenditures effective as of December 31, 1996. As of December 31, 1997 the Company incurred renouncable exploration expenditures of $6,496,000 (1996 - $6,277,646). To recognize the foregone tax benefits to the Company, the carrying value of the property and equipment costs and the Class B shares have been reduced by $2,841,301 (1996 - $2,716,208).

During 1997, 771,976 Class A share purchase warrants were exercised to acquire 771,976 Class A shares for consideration of $1,157,964.

Flow-through issues

On December 16, 1996, 220,500 Class A flow-through shares were issued at $2.25 per share for $496,125. In accordance with the terms of the private placement, the Company renounced, for income tax purposes, to the holders of the Class A flow-through shares, $496,125 of exploration expenditures effective as of December 31, 1996. The Company incurred the related expenditures during 1997 and recognized the foregone tax benefits by reducing the carrying value of the property and equipment costs and Class A shares by $219,665.

On December 23, 1996, the Company issued 308,000 flow-through exchange rights at $2.27 per flow-through right for $699,160. Each flow-through right entitles the holder to exchange one flow-through right for one Class A share without any additional consideration. In accordance with the terms of the flow-through exchange rights agreement, the Company renounced, for income tax purposes, to the holder of the exchange rights, $699,160 of exploration expenditures effective as of December 31, 1996. The Company incurred the related expenditures during 1997 and recognized the foregone tax benefits by reducing the carrying value of the property and equipment costs and Class A shares by $309,562. As at December 31,1997 none of the exchange rights have been exchanged.

In October and November, 1997, the Company issued 490,300 Class A flow-through shares at $1.65 per share for $808,995. In accordance with the terms of the agreement, the Company renounced for income tax purposes $808,995 of exploration expenditures effective as of December 31, 1997. The Company incurred a portion of the related expenditures in 1997 and recognized the forgone tax benefits by reducing the carrying value of the property and equipment costs and Class A shares by $134,501.

On December 16, 1997, the Company agreed to issue 450,000 Class A flow-through shares at $1.65 per share for $742,500. In accordance with the terms of the agreement, the Company renounced for income tax purposes $742,500 of exploration expenditures effective as of December 31, 1997. At December 31, 1997, 450,000 Class A shares are reserved for issue and $742,500 is included in accounts receivable. Subsequent to year end, the Company received the $742,500 and issued the 450,000 Class A shares.

Escrowed shares

At December 31, 1997 475,200 (1996 - 633,600) of the Class A shares issued to the founders were held in escrow to be released as to 158,400 annually.

Stock option plan

The Company has established a stock option plan whereby up to 10% of the issued Class A common shares will be available for purchase by the directors, officers and employees of the Company.

	1997
Options outstanding, beginning of year	**315,000**
Granted	**147,000**
Exercised	**(15,000)**
Cancelled	**(75,000)**
Options outstanding, end of year	**372,000**

The stock options vest over a three year period from the date of grant and, if unexercised, will expire on the fifth anniversary from the date of grant. Stock options outstanding, as at December 31, 1997 were exercisable at prices ranging from $1.30 to $2.05.

Share issue costs

For the year ended December 31, 1997, share issue costs of $37,462 (1996 - $800,378) are presented net of deferred income taxes of $16,518 (1996 - $352,167).

6. DEFERRED INCOME TAX PROVISION

The provision for deferred income taxes is different from the amount computed by applying the combined statutory Canadian Federal and Provincial tax rates to earnings before deferred income taxes. The reasons for these differences are as follows:

	1997	1996
	$	$
Corporate income tax rate	**44.62%**	44.62%
Computed expected provision for income taxes	**(373,000)**	148,000
Increase (decrease) in taxes resulting from:		
Non-deductible crown charges	**193,000**	43,000
Alberta royalty tax credit	**(121,000)**	(32,000)
Resource allowance	**(157,000)**	(20,000)
Non-deductible depletion	**458,000**	63,000
Tax benefit of loss carryforward not recognized	**166,685**	–
Deferred income tax provision	**166,685**	202,000

The following deductions are available for future income tax purposes:

	1997	
	$	Annual Rate of Claim
Canadian development expense	**213,000**	30%
Canadian exploration expense	**2,405,000**	100%
Canadian oil and gas property expense	**486,000**	10%
Undepreciated capital cost	**1,322,100**	20 - 100%

7. (LOSS) EARNINGS AND FUNDS FROM OPERATIONS PER CLASS A SHARE

1997	**Basic**	**Fully Diluted**
Loss per Class A share	**(0.23)**	**(0.23)**
Funds from operations per Class A share	**0.36**	**0.17**
Weighted average number of Class A shares outstanding	**4,305,914**	**9,425,278**

1996	Basic	Fully Diluted
Earnings per Class A share	0.04	0.02
Funds from operations per Class A share	0.13	0.06
Weighted average number of Class A shares outstanding	3,579,062	8,392,653

Fully diluted earnings per Class A share and fully diluted funds from operations per Class A share have been calculated assuming that the Class B shares were converted into Class A shares at the beginning of 1997 using the December 31, 1997 closing price of $1.45.

Proceeds from the exercise of stock options and warrants are assumed to have been invested in short term deposits at a pre-tax yield of 3% per annum.

8. COMMITMENT

The Company is committed to an operating lease for office premises. Future payments are as follows:

	$
1998	60,671
1999	60,671
2000	60,671
2001	60,671
	242,684

CORPORATE INFORMATION

BOARD OF DIRECTORS

Kevin McLachlan
President

Ian Collar
Vice-President, Exploration

John Gareau
President, Pentagon Energy Inc.

Ronald Quillian
Independent Businessman

OFFICERS AND KEY PERSONNEL

Kevin McLachlan
President

Ian Collar
Vice-President, Exploration

Gregory Turnbull
Secretary

Carla Carr
Corporate Administrator

Garth Fordyce
Manager, Land & Contracts

Kevin Wright
Manager, Engineering

CONSULTANTS

Rita Bertwell
Accounting Representative

Norman Jeal
Geological Consultant

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REGISTRAR AND TRANSFER AGENT

Montreal Trust Company of Canada
Calgary, Alberta

SOLICITORS

Code Hunter Wittmann
Calgary, Alberta

STOCK EXCHANGE LISTING

The Alberta Stock Exchange
Trading Symbols
Class A Shares: KNN.A
Class B Shares: KNN.B

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